

## **7100 PROPERTY FACTOR**

The numerator of the property factor is the average value of all real and tangible personal property owned or rented and used in California for the production of business income. The denominator is the total of all such property owned or rented by the taxpayer everywhere (R&TC §25129). This portion of the manual first discusses the general topics relating to the property factor. Next, specific rules and audit techniques are discussed with respect to certain items:

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**7110 RECONCILIATION OF THE PROPERTY FACTOR****Denominator:**

The starting point for examining the property factor should be a reconciliation of the denominator of the property factor with property per annual reports, SEC 10-Ks, or audited financial statements. If the combined group is not the same as the consolidated group included in the financial statements, the consolidating workpapers will usually disclose the data on a company-by-company basis. For small, privately held corporations that do not have audited financial statements, the reconciliation may be made directly to the taxpayer's trial balance and/or property records.

The balance sheet of the Federal Form 1120 may not be a reliable source for reconciliation. Since the Form 1120 balance sheet does not directly affect federal taxable income, it is not essential that it be accurate, and it is not always audited by the IRS. Property balances per the federal depreciation schedules are subject to IRS scrutiny, but those schedules may not include fully depreciated property or land. Although Form 1120 data is often a convenient source for performing preliminary test checks, the results should be verified against other sources.

The taxpayer's apportionment workpapers are helpful for determining how the factors were computed, but it is never acceptable to reconcile tax return figures to the workpapers unless the workpapers have themselves been reconciled to a reliable source (such as financial statements or property records).

The reconciliation is performed by averaging the beginning and ending property values per the financial statements, and comparing the result with the owned property in the denominator of the factor. The original cost basis of the property should be used for this reconciliation. If the balance sheets report depreciable assets net of depreciation, the notes to the financial statements will usually disclose the assets balances prior to depreciation. If construction-in-progress is identified in the financial statements, it should be excluded.

Rented property may be reconciled by multiplying rent expense per the Form 1120 return by 8, and comparing the result to capitalized rents in the denominator. Rents in the 1120 are most commonly located on line 16, in Cost of Goods Sold, or on line 26 "Other Deductions."

The taxpayer should be asked to reconcile any material differences identified in the property reconciliations. The property ledgers may be used for verification if necessary. Any unusual balances or unreconciled amounts should be flagged for further investigation.

One reason for property value differences between book and tax may be due to business acquisitions. For tax purposes, property is generally carried at historical cost, regardless of whether the stock of the corporation changes hands. For book purposes however, generally accepted

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accounting principles (GAAP) generally require that the "purchase method" be used to add newly acquired corporations to the consolidated financial statements. Under the purchase method, if the consideration given for the stock of the new corporation exceeds the book value of the assets and liabilities, then the balance sheet is reviewed. If any assets can be identified as being undervalued or overvalued, then adjustments are made so that the consolidated balance sheet will reflect the fair market value of those assets. The amount that is charged to goodwill is only the amount of excess purchase price over book value of the acquired corporation that cannot be specifically allocated to any asset. If the acquired corporation remains separately incorporated, the adjustments to asset values are consolidating adjustments and will not be posted to the separate books of the corporations. A review of the consolidation workpapers should reveal the adjustments. If the acquired corporation is merged into the acquirer, then the adjusted property values will be posted to the acquirer's books. To determine whether asset balances were materially adjusted, it may be necessary to review the journal entries accomplishing the merger or to compare pre-acquisition balance sheets or property ledgers of both the acquirer and acquired corporation with the post-acquisition balance sheet. (If asset values have been materially stepped-up, the auditor should also verify that depreciation or amortization of the stepped-up amounts is not being taken for California purposes. See MATM 6015.)

**Numerator:**

The taxpayer's records will usually show the location of property on a state-by-state basis. The total of all property as shown on this schedule should be compared to the amount reported in the denominator. If there is no material difference, the auditor will be assured that the numerator amounts shown for the different states account for all property. The auditor should keep in mind, however, that audit adjustments to the denominator might require corresponding adjustments to the numerator.

Property tax bills may also be examined to identify or verify the location of property.

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**7115 REAL AND INTANGIBLE PERSONAL PROPERTY – IN GENERAL**

Only real property and tangible personal property is included in the property factor (R&TC §25129). Since intangible property is not specifically included under the statute or regulations, it is generally excluded from the factor. (An exception to this rule is made under CCR § 25137-4 and CCR §25137-10 for banks and financial corporations. For unitary groups that include banks or financial corporations, refer to the Bank and Financial Handbook.

A question may sometimes arise as to whether an asset should be considered tangible or intangible. The Board of Equalization addressed this issue in the following case:

In *Appeal of Retail Marketing Services, Inc.*, Cal. St. Bd. of Equal., August 1, 1991, the issue involved whether coupons were tangible personal property includable in the property factor. Merchants would sell the taxpayer coupons that had been redeemed from shoppers. The taxpayer then collated the coupons and resold them to the respective manufacturers. The coupons were recorded as inventory on the taxpayer's accounting records, and the taxpayer sought to include them in the property factor under the theory that they were tangible assets. The SBE disagreed, finding that property is intangible for property factor purposes if its intrinsic value is attributable to its intangible elements rather than to any of its specific tangible embodiments. In this case, the coupons had no intrinsic value to a consumer apart from the discount received upon presentation to the merchant. The coupons represented a customer's "right" to the discount, and property that is a right rather than a physical object is intangible. The SBE further held that the taxpayer had failed to prove that exceptional circumstances were present which would require a deviation from the standard apportionment formula.

For a discussion of the issue of tangible vs. intangible property in the context of computer software, see MATM 7152.

The notes to the financial statements should disclose the taxpayer's intangible assets. The reconciliation of property to the financial statements, along with a review of the accompanying notes, will reveal whether intangible assets have been included in the factor. A review of the taxpayer's apportionment workpapers may also be of assistance in identifying intangibles in the factor.

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**7120 VALUATION OF OWNED PROPERTY**

Property owned by the taxpayer is valued at its original cost before any allowance for depreciation (R&TC §25130, also see Regulations). This will generally be the federal tax basis at the time of acquisition by the taxpayer (adjusted by any subsequent capital improvements). In cases where there is a material difference between federal tax basis and the taxpayer's basis for California tax purposes, auditors may consider whether the facts warrant property factor valuation using the California basis as an exception to the general rule.

If the original cost of property cannot be determined, the property is included in the factor at its fair market value as of the date of acquisition.

Property acquired by gift or inheritance is included in the factor at the basis used for determining depreciation for federal income tax purposes (CCR §25130(a)(3)). In situations such as a tax-free reorganization where the transferor's basis carries over to the transferee, the transferor's original cost will also carry-over to the transferee for property factor purposes (CCR §25130(a)(1), ex. (B)). If the reorganization is not completely tax free, the original cost will be the transferor's basis plus the gain recognized on the transactions.

Replacement property acquired as the result of an involuntary conversion will generally be included in the property factor at the original cost of the converted property if nonrecognition treatment was received on the transaction. If gain was recognized on the conversion, then the cost of the replacement property will be used. See [FTB Legal Ruling 409](#) (10/6/77), for more information regarding property factor treatment of replacement property acquired after an involuntary conversion.

Occasionally, taxpayers have the option of either capitalizing expenditures related to property (such as research expenditures), or currently expensing the costs. With the exception of intangible drilling costs (which are discussed in MATM 7795), only capitalized expenditures will be included in the property factor. The value of the property includable in the factor will therefore vary depending upon which method the taxpayer elects. See MATM 7153 for a further discussion of this issue with respect to research and software development costs.

In performing the reconciliation of the property factor to the balance sheets, the notes to the financial statements should be reviewed for any indication that the book values may be different than the federal tax basis. For example, if the financial statements indicated that assets had been revalued and written-down, the auditor should expect the property values in the denominator to be higher than the values in the balance sheets. Depreciable assets in the property factor may also be reconciled to the tax depreciation schedules. Any significant differences may indicate that the property is not valued at its federal cost basis.

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7121 Intercompany Profits In Assets

When assets are transferred in an intercompany sale, the economic position of the unitary group does not change. It is therefore the Department's position not to recognize any increase in basis of assets for property factor purposes where assets have been sold between members of a combined group and the gain has not been recognized.

For federal tax purposes, gain on intercompany sales of assets is generally deferred. Although the gain is not recognized in the year of the intercompany sale, the buyer's basis in the asset is stepped up to reflect their cost. Recognition of the deferred gain is triggered in increments as the buyer depreciates the stepped-up basis of the asset, or in full in the year that the asset is disposed of outside the consolidated group. (See Treas. Reg. 1.1502-13, also MATM 5260.) Although California allows taxpayers to defer recognition of most intercompany gains in accordance with the federal rules, such treatment is not allowed to extend to the apportionment formula. This interpretation prevents the manipulation that could occur if taxpayers were allowed to step-up the basis of property in certain states through intercompany sales.

Material intercompany transfers of assets due to reorganizations or business restructurings may be disclosed in the annual reports, SEC 10-Ks, or notes to the financial statements. An analysis of relative property balances between the members of the unitary group may also provide an indication that an intercompany transfer of assets took place. For example, if Corporation A had sold a material asset to Corporation B, Corporation A's property would decrease while Corporation B's property would increase. If the auditor suspects that an intercompany sale has taken place in a prior year, purchase documents should be examined to establish whether the asset was acquired from a unitary affiliate. If so, the value included in the property factor should be verified to be the unitary seller's original cost (unless the taxpayer made an election not to defer the gain or loss on the intercompany sale - see MATM 5260).

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## 7125 Averaging Property Values

The average value of owned property included in the factor is usually determined by averaging the values at the beginning and ending of the taxable year. The department may require or allow averaging by monthly values where necessary to properly reflect the average value for the taxable year (R&TC §25131). This may occur where significant assets were acquired or disposed of during the year.

In the *Appeal of Craig Corporation*, Cal. St. Bd. of Equal., March 3, 1987, the taxpayer disputed FTB's use of a quarterly average, asserting that only the annual inventory figures were audited, and accurate numbers. The SBE upheld the FTB determination, stating that the department had not abused its discretion. Since the same source of quarterly data was used in both the numerator and denominator, it did not appear that the flaws in the data would produce a distortive result. The SBE also allowed FTB's use of a quarterly average since monthly figures were not available.

CCR §25131 contains an example of a monthly average computation. The example computes a 12-month average based on the average property values for each month (the January value is the average of Jan. 1 and Jan. 31; the February value is the average of Feb. 1 and Feb. 28, etc.). Another way of computing a monthly average would be to add the beginning of the year property value to the month-end values for each month of the taxable year, and then divide by 13. (Example: [Dec. 31 + Jan. 31 + Feb. 28 + . . . + Nov. 30 + Dec. 31] / 13 = monthly average.)

If a fluctuation in asset values occurs only with respect to one member of a combined group, or if one member is not included in the group for the entire year, it is possible to average the assets of that member separately from the remainder of the group. This avoids having to compute a monthly average or other weighted average for every member of the group. Following is an example of this computation:

### Example

Assume that Corporations A, B, C and D are members of a unitary group filing on a calendar year-end. The property values of A, B and C remained relatively stable during 1993, but Corporation D was formed during the year and did not acquire any assets until October 1, 1993. The average value of the owned property for 1993 may be computed as follows:

|  |         |
|--|---------|
| Combined property of A, B & C, computed using a simple average of the values at January 1, 1993 and December 31, 1993: | \$      |
|  | 100,000 |
| Property of D:   |         |
| October  | 20,000  |
| November   | 40,000  |



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|   |               |              |
|---|---------------|--------------|
| December  | <u>50,000</u> |              |
|   | 110,000       |              |
| Divide 12   |               |              |
| Weighted Average:                                   |               | <u>9,166</u> |
| Average property of the combined group (A,B,C & D): |               | \$           |
|   |               | 109,166      |

When preparing schedules to compute adjustments to the property factor, care should be taken to determine the effect of the adjustments on the averages. In the preceding example for instance, Corporation D's property would not be included in the year-end balance for computing 1993 average property for the rest of the group. On the other hand, D's property *would* be included in the beginning balance for computing the 1994 average property of the group. This is an exception to the general practice of picking up the ending balances for one year as the beginning balances for the following year.

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**7130 VALUATION OF RENTED PROPERTY**

Rented property is valued at eight times its net annual rental rate. The net annual rental rate is the annual rental rate less any nonbusiness subrentals (R&TC §25130). Occasionally taxpayers will interpret R&TC §25131 as requiring rented property to be averaged somehow. This treatment is incorrect. The only allowable method for including rented property in the factor is pursuant to the capitalization described in R&TC §25130. The taxpayer's apportionment workpapers will usually disclose whether rents have been properly capitalized.

The taxpayer's chart of accounts is often a good way to identify the areas where rent expense has been booked. Once the accounts have been identified, the trial balance or general ledger can be used to verify rent expense. The notes to the financial statements in the annual reports or SEC 10-Ks will usually disclose rent expense incurred with respect to capital leases (see MATM 7200). This information is useful for reconstructing rent expense for worldwide combinations where foreign rents are not otherwise available, but the auditor should be cautious about the fact that the financial statements do not always disclose rent expense from operating leases. Likewise, rent expense deducted on the tax returns is sometimes buried in various accounts, and it is not always evident solely from reviewing the return.

The taxpayer's workpapers will often show rent expense on a state-by-state basis. The aggregate state amounts should be compared to the total rent expense to ensure that all rents are accounted for in the numerator.

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7131 Annual Rental Rate

The annual rental rate is the amount paid as rental for property for a 12-month period. If the property has been rented for less than a 12-month period, the rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period. However, where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a short period of less than 12 months, the rent paid for the short tax period shall be annualized. In a combined report situation, everyone included in the combined report must have a short period in order to annualize the rents. If one of the corporations in the combined report has a short period, but not all of the corporations, the rent should not be annualized for the short period taxpayer because the entire property factor for this taxpayer needs to be weighted due to the fact that they are not included for the entire 12-months. CCR §25130(b)(2) contains examples of the annualization computation.

The purpose of annualization is to put rented property on a parity with owned property. If a taxpayer owns \$800,000 of property at the beginning of a short period, and the same \$800,000 at the end of the short period, its average value of owned property is \$800,000. This is not true of rented property. Assume a taxpayer leases the property for \$100,000 per year over a five-year period, and because of a change of accounting period has a short taxable year of only six months. Annualization requires the taxpayer to capitalize the annual rental rate of \$100,000, for a value of \$800,000 in the property factor. Without annualization, the taxpayer would capitalize the actual rent expense paid by 8, and only include a value of \$400,000 ( $\$50,000 \times 8$ ) in the property factor.

Annualization only applies if the rental term is for 12 or more months. Because month-to-month rentals are of uncertain duration, they are not considered to be "for a term of 12 or more months" for purposes of annualization.

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**7132 Intercompany Rents**

Intercompany rents between members of a combined report are eliminated from the property factor. The reason for the elimination is that the original cost of the asset has already been included in the factor by the lessor. Inclusion of the capitalized rents in the factor by the lessee would result in the asset being represented twice.

Consolidating working papers for the financial statements should identify intercompany rents in the eliminations column. Under the federal rules for intercompany transactions however, intercompany rents are generally a period expense (deductible by the paying member in the same period as they are reported by the receiving member), and are therefore usually not eliminated on the Federal Form 1120. When consolidating workpapers to the financial statements are not available in sufficient detail to be of assistance, an analysis of rental income may be necessary. The chart of accounts may also be useful in identifying intercompany rents. If the transaction is material enough, it may be disclosed in the notes to the financial statements.

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**7133 Advance Rentals**

Advance rentals are neither deductible in the current year nor capitalized in the property factor for that year. For example, assume that the first and last month's rent of a five-year lease are paid at the inception of the lease. The first month's rent is deductible in the first year, but an accrual basis taxpayer cannot deduct the last month's rent until the fifth year when the economic performance occurs (Treas. Reg. 1.461-4). Since the last month's rent is not paid for the use of the property during the first year tax period, it is not capitalized in the property factor until the fifth year.

If the taxpayer has reported rents correctly for federal purposes, rent expense per the Form 1120 return should not include advance rentals.

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**7134 Nonbusiness Subrentals**

Annual nonbusiness subrentals paid by subtenants of the taxpayer are deducted from the annual rental rate to arrive at the net annual rental rate. The reason for this reduction is that only a portion of the rented property is being used to generate business income, so only a corresponding portion of the rent expense should be capitalized. Subrents are not deducted when they constitute business income because the property is still being used for business purposes when it produces such subrents. Examples of business vs. nonbusiness subrents may be found in CCR §25130(b)(1). Analysis of rental income and rental expense per the Federal Form 1120 return or the general ledger accounts should disclose whether subrentals exist. If the subrents are material, the normal tests for determining whether they constitute business or nonbusiness income should be applied (MATM 4045).

If deduction of nonbusiness subrents produces a negative or clearly inaccurate value for the portion of the property used in the business by the taxpayer, CCR §25137(b)(1)(A) provides that another method of valuing the rented property may be applied. The Regulation contains an example of the minimum value that may be used in such a situation.

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**7136 DEFINITION OF RENT**

For purposes of the property factor, rents are defined as the actual sum of money or other consideration payable, directly or indirectly, for the use of the property. This includes payments that are computed as a percentage of sales, profits, or otherwise. The definition also includes amounts paid for interest, taxes, insurance, repairs, or any other items provided that such payments are made pursuant to the terms of the lease as additional rent or in lieu of rent (such an arrangement is often referred to as a "net lease"). An examination of the lease agreements should disclose the existence of such charges.

Rents do not include amounts paid for services (utilities, janitor services, etc.; see also MATM 7137 (Rent Expense vs. Payment for Services)). Nor do rents include items such as hotel accommodations or daily car rentals because such payments are considered to be incidental day-to-day expenses of the business. The nature of the rented property will not always identify whether the rents are includable in the factor. For example, automobiles may be rented on a daily basis (not includable), or may be subject to long-term lease contracts (includable). If material, it may be necessary to inspect the rental documents to determine the nature of the transaction.

Occasionally, non-includable service charges will be included in rents, but the amounts will not be segregated in the rental contract. For example, if a taxpayer rents storage space in a public warehouse for its inventory, a portion of the rent payment will be attributable to the use of the storage space, and a portion may be attributable to handling fees, inventory insurance, etc. (see CCR §25130(b)(3)(B), ex. (B)). If the fees are not broken down in the contract, it will be necessary to allocate the payments in accordance with the relative values of the rent and the other services. The taxpayer may be asked to obtain detail regarding the storage fees from the storage company, or the auditor may choose to make inquiries directly with the storage company.

The definition of rents does include royalties based on the extraction of natural resources that are paid or credited to a holder of an interest in the property, so long as the property for which the royalty payments are made is actually used by the taxpayer. [FTB Legal Ruling 97-2](#) provides that such royalties shall be treated as equivalents to rental payments. Also, the State Board of Equalization in *Appeal of Proctor and Gamble* concluded that 18 CCR §25137(b)(1)(B) authorizes the capitalization of royalties in a case such as this.

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7137 Rent Expense Vs. Payment For Services

It is sometimes difficult to determine whether a contractual arrangement is a rental of property (includable in the property factor) or a service contract (excluded). Although this issue may arise in many contexts, it has been most commonly seen with respect to sea transportation contracts such as time charters, voyage charters, bareboat charters, contracts of affreightment, and similar arrangements.

Time or voyage charters are contracts whereby a vessel owner supplies a vessel, crew and supplies for a specified period of time or for a particular voyage. In a bareboat charter, the taxpayer contracts for the use of the ship, and provides its own crew and supplies. In a contract of affreightment, the contract is not for the entire vessel, but for a specified amount of space on the vessel.

Whether such contracts constitute leases or service contracts will depend upon the facts of each particular case. Prior to 1984, federal case law had developed certain criteria to apply to determine whether a contract was a service contract or a lease. Such criteria focused on the degree of possession and control enjoyed by the parties (See *Xerox Corporation v. United States*, 656 F2d 659 (1981)). In 1984, IRC §7701(e) was enacted to provide specific factors to be considered in making the determination. California conformed to IRC §7701(e) in 1985 (R&TC §23047). Auditors who are faced with this issue may also refer to the following Board of Equalization decision:

In *Appeal of Castle and Cooke*, Cal. St. Bd. of Equal., June 17, 1987, the taxpayer was engaged in buying, shipping and selling tropical fruit. The fruit was shipped from Latin America in refrigerated vessels under either time charter arrangements or contracts of affreightment. The taxpayer capitalized the transportation costs in the property factor as rental expenses. The SBE held that the costs were not leases, but merely transportation expenses. Using the criteria set forth in *Xerox*, the SBE found that the taxpayer did not have the type of control over the property requisite for the transaction to be a lease because the owners of the vessel not only retained access to the property, but also retained physical control over the vessel, its operations, and its crew. In addition, the SBE stated that what the taxpayer was really contracting for was an integrated package of services including adequate space and conditions for its produce while being transported, with payment being for the end result -- delivery at the port of destination. The fact that tangible personal property was used in achieving that end result does not change a transportation contract into a lease.

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**7138 PROPERTY OF ANOTHER USED FOR NO COST OR NOMINAL COST**

Occasionally, property owned by others may be provided for the taxpayer's use at no cost, or for nominal cost. CCR §25137(b)(1)(B) provides:

*"If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property shall be determined on the basis of a reasonable market rental rate for such property."*

The inclusion of property owned by others in the property factor raises the following difficult issues:

Whether or not the taxpayer has a possessory interest in the property;

Whether or not such property has actually been "used" in the taxpayer's business; and

The determination of the "reasonable market rental rate."

The SBE has addressed this issue in the following published decisions:

In *Appeal of The Procter & Gamble Manufacturing Company, et al.*, Cal. St. Bd. of Equal., September 26, 1989, the taxpayer had executed a Forest Management Agreement with the Province of Alberta, Canada for 3.5 million acres of timberland. Alberta retained title to the timberland, but the taxpayer was granted rights to harvest timber and to otherwise have extensive use of the land. The taxpayer agreed to pay Alberta \$1.15 a cord for the harvested trees, and they were also obligated to pay an annual "holding charge" of \$3 per square mile and a "forest protection charge" of \$12.80 per square mile. The taxpayer included the timberland in the denominator of its property factor at a value of \$399 million. This purportedly represented the fair market value of the entire timberland in the year that the land was placed in productive use.

The FTB contended that because the timberland was not "owned or rented and used" by the taxpayer, no value associated with it may be included in the property factor. The SBE disagreed, holding that CCR §25137(b)(1)(B) applied and that an appropriate amount must be included in the denominator. On the other hand, the SBE did not consider the fair market value of the property to be an appropriate substitute for the reasonable market rental rate. Although they did not prescribe a particular approach to be used in constructing the reasonable market rental rate, the SBE did not accept FTB's proposal to compute a rental rate of \$15.80 per square mile (computed by adding the annual "holding charge" and "forest protection charge"), reasoning that it was still no more than a nominal rate of rent.

The *Appeal of Union Carbide Corporation*, Cal. St. Bd. of Equal., April 5, 1984 (Union Carbide I), also dealt with the issue of whether the taxpayer properly included government-owned property in the property factor. During the appeal years, the taxpayer operated four nuclear facilities for the federal government under a "cost-plus-fixed-fee" contract. No rent was paid, but the taxpayer had exclusive use of the facilities. The taxpayer included a "value" for the property in the denominator.

The FTB excluded the "value" of the government-owned plants on the theory that the taxpayer could only invoke the use of CCR §25137(b)(1)(B) if they showed that exceptional circumstances existed for the use of a special apportionment method. The SBE found that by having a specific regulation on the subject, FTB must be considered to have implicitly agreed that the existence of property owned by others and used at no cost is in itself an exceptional circumstance requiring a special formula. No issue was raised in this case regarding the reasonableness of the value assigned to the property by the taxpayer.

The *Appeal of Union Carbide Corporation*, Cal. St. Bd. of Equal., January 13, 1993 (Union Carbide II) dealt with the subsequent audit cycle of Union Carbide. The FTB again excluded the government property from the property factor, this time on the basis that the taxpayer did not have a possessory interest in the property. The SBE rejected that argument and reaffirmed their holding in Union Carbide I.

The valuation issue was also addressed in this case. Both the FTB and the taxpayer had obtained appraisals to support a "reasonable market rental rate." The SBE determined that the FTB appraisal was based on the underlying assumption that the benefits to be received from using the property would be restricted to reasonable fees for managing the property. Apparently, however, the taxpayer received significant benefits from the property other than just management fees (for example, the taxpayer was able to utilize its research connected with the government contract to develop its own products). Since the FTB's valuation approach did not take these other benefits into account, the SBE concluded that the valuation did not reasonably approximate what the federal government could expect to receive from a willing lessee.

The taxpayer's appraisal derived a valuation that was intended to represent the return that a prudent investor would require on an investment in the property. Although the SBE made some modifications to the valuation computation, they accepted the general approach of this valuation.

In cases where a taxpayer has rights to extract minerals or harvest timber from property that it does not own, the issue of how (if at all) that property should be included in the property factor is contained in [FTB Legal Ruling 97-2](#). The Ruling announces that the mineral or timber royalties paid by the taxpayer will be considered substantially equivalent to the reasonable market rental rate.

CCR §25130(b)(4)(B) specifically provides that royalties based on the extraction of natural resources are not included in the definition of "rents" for standard property factor purposes. However, the "use of

property of another" provision is a deviation from the standard apportionment formula under the CCR §25137, and the Legal Ruling explains that these types of royalties are sufficiently equivalent to rents to be used as a reasonable approximation for purposes of R&TC §25137. An important concept to remember is that CCR §25137-1(b)(1)(B) requires that the property be used and that a net annual rental rate be capitalized. For example, a corporation that has a right to harvest timber over 99 years, but is limited to 1/99<sup>th</sup> of the timber each year is only using 1/99<sup>th</sup> of the total property. The amount of royalties paid during the year is presumed to be the annual rental rate.

The analysis in [Legal Ruling 97-2](#) is an interpretation of existing law, so it applies retroactively to all open years. If you are auditing a taxpayer that conducts mining, oil & gas drilling or timber-harvesting operations on government-owned property (or on any other property not owned by the taxpayer), any adjustments to the property factor should be made on a basis consistent with this ruling. Note, however, that the ruling does not apply to other CCR §25137(b)(1)(B) issues such as a taxpayer's operation of a government-owned plant. Also, the burden of proof is upon the taxpayer to disclose the value of other types of property such as the free use of a government dry dock to overhaul a Navy ship.

Since the determination of whether property owned by another should be included in the property factor is based on the unique facts and circumstances of each particular case, it is essential that auditors fully develop the relevant facts and obtain documentary evidence of those facts. Following are some suggestions for information that auditors should obtain when faced with this issue:

- Full copies of all agreements and contracts between the taxpayer and the other entity involved. (As with any other contracts, signed copies should be requested to ensure that the final version has been provided.)
- Details of the taxpayer's separate accounting for the revenues and costs derived from activity related to the property.
- A full description of the relationship between the taxpayer and the owner of the property, and the relationship of the taxpayer to the physical property in question. Factors, which should be addressed, include:
  - The rights of the owner with respect to the physical property. For example, did the owner retain possession or control, or a right of access?
  - The rights of the taxpayer with respect to the physical property. For example, did the taxpayer have a right of possession or control, or a right to exclude the owner from the property? Did the taxpayer have a right to enter land to take timber or minerals, or for some other purpose?
  - The use that the taxpayer makes of the property.
  - Whether the taxpayer undertakes any risk as to loss of the property.
  - Whether the owner reserves the right to provide substitute property.

Where the taxpayer has included a value for the property in the property factor, full documentation supporting the valuation. This would include copies of the calculations of the amounts claimed, as

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well as copies of any appraisals obtained by the taxpayer. Auditors may investigate whether the valuation of the property was at issue in a property tax case in the state or country where the property is located.

It may be appropriate at the audit stage for the department to contract for its own independent appraisal of the property. In cases where the auditor and supervisor determine that an outside appraisal is warranted, management should be consulted before any steps are taken to secure the appraisal.

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**7140 USED OR AVAILABLE FOR USE**

Property is included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the unitary business (CCR §25129(b)). Natural resources that are held in reserve are considered to be in use or available for use while in reserve status, so they are included in the factor even though active development of the resources has not yet taken place.

In *Appeal of Tosco Corporation*, Cal. St. Bd. of Equal., November 18, 1980, the issue was whether the taxpayer had properly included its interest in oil shale reserves in the property factor. Over a 20-year period, the taxpayer was engaged in the development of technology to recover hydrocarbons from oil shale rock. This development was intended to culminate in the construction of a commercial plant, although the plant had not been built as of the date of the appeal due to economic and environmental problems. Over the 20-year period, the taxpayer had been purchasing oil shale reserves in anticipation of the commercial production. FTB removed the reserves from the property factor on the basis that they were not capable of being used in the business since the plant had not yet been built. The SBE concluded that the oil shale reserves were available for use, and were therefore appropriately included in the factor.

Once property has been used in the regular course of the trade or business and included in the property factor, it remains in the factor until an identifiable event establishes its permanent withdrawal from the business (CCR §25129(b)). Conversion of the property to nonbusiness use would be an example of such an identifiable event. Property that is temporarily idle is still available for use, as is property that is for sale (however if the property has not been sold after an extended period of time (normally five years), it is removed from the factor). While property is held for sale, temporary rental of the property will not cause its removal from the factor. CCR §25129(b) contains several examples of what constitutes (or does not constitute) an identifiable event.

The *Appeal of Ethyl Corporation*, Cal. St. Bd. of Equal., March 18, 1975, was a pre-UDITPA case involving the taxpayer's exclusion of a partially dismantled plant from the property factor. Although it would only be economically feasible to resume operations at the plant under certain unusual conditions, the fact remained that the plant was available for limited use in the unitary business, and was capable of such use. The SBE held that it was properly includable in the factor.

In the *Appeal of Thor Power Tool Company*, Cal. St. Bd. of Equal., April 8, 1980, the taxpayer closed a plant and then held the property for sale. Since the building was deteriorated, the taxpayer demolished it to facilitate the sale of the land. The SBE concluded that although the building was appropriately removed from the factor when it was demolished, the land could still have been put to use in the unitary business. The demolition of the building therefore did not constitute an identifiable event resulting in the permanent withdrawal of the land from the property factor prior to its sale.

Reviewed: December 2002

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7142 Construction In Progress

Property or equipment under construction during the taxable year is excluded from the property factor until such property is actually used in the regular course of the trade or business (CCR §25129(b)). The exception to this rule is inventoriable goods in process (see MATM 7171).

If the property is partially used in the regular course of the trade or business while under construction, only the value of the property to the extent used is included in the property factor (CCR §25129(b)). Since only the portion of the property that is being used is subject to depreciation, the taxpayer should have identified the basis attributable to the portions in use on their depreciation schedules.

In some industries, such as the electronics industry, equipment may be acquired subject to approval after the equipment has been operated for a period of time. Some taxpayers charge the assets to a "construction in progress" account until the equipment is finally accepted or rejected. In other instances, self-constructed property is held in the "construction in progress" account while it is being subjected to an extended period of testing in the actual production environment. Under both of these conditions, the equipment is being used in the current production of income, and should therefore be included in the property factor. If the auditor suspects that either of these conditions exist and the amounts are material to the property factor, the auditor should analyze the construction in progress account and inquire to what extent the assets are being used in the business.

Rent paid for tangible personal property used in the construction of an asset should be capitalized into the cost of the asset (Treas. Reg. §1.263A). For example, if a taxpayer constructed its own building using rented scaffolding, the scaffolding rent is capitalized into the cost of the building. Since the cost of the building is not included in the property factor until it is available for use, it follows that the rent paid for the tangible property used during the construction should not be reflected in the property factor as it is not being "used in the business." Therefore, the rent paid for the scaffolding would not be included in the property factor. Once the building is placed in service, the federal tax basis of the building will include the rents charged to the construction in progress account.

Construction in progress is usually disclosed in the notes to the financial statements. It is also generally segregated in the general ledger and the property ledger. An analysis of the components of the construction in progress account may reveal items that have been inappropriately excluded from the factor.

Reviewed: December 2002

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**7150 COMPUTER EQUIPMENT AND PROGRAMS**

|           |                            |
|-----------|----------------------------|
| MATM 7151 | Hardware                   |
| MATM 7152 | Software                   |
| MATM 7153 | Expense vs. Capitalization |
| MATM 7155 | Foreign Property           |

Reviewed: December 2002



**7151 Hardware**

Computer equipment (hardware) is tangible personal property and is subject to the normal rules for inclusion in the property factor at original cost. If the hardware is rented, the net annual rents are capitalized by eight. If computer rentals are material to the property factor however, the auditor should review the rental agreement to verify that the transaction is actually a rental rather than fees paid for computer services.

Reviewed: December 2002

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7152 Software

The treatment of computer software (programs) in the factor is more problematic. Since computer software consists of both a tangible element (the disk or other storage medium) and an intangible element (the intellectual content), issues have arisen regarding whether the software as a whole is tangible or intangible. In the past, the department had taken the position that canned or prewritten software should be treated as tangible property, and custom software should be treated as intangible property. This characterization was consistent with the treatment for California sales tax purposes. Based on the California Supreme Court's decision in *Navistar International Transportation Corporation v. State Bd. of Equalization*, (1994) 8 Cal.4<sup>th</sup> 868, however, the position may be taken that both canned and custom software are tangible property and therefore includable in the property factor:

*The Navistar case* involved the sale of a division to an unrelated third party. One category of the assets sold consisted of custom software that had been developed by Navistar for use in its business. This case dealt with whether the sale met the statutory sales tax exclusion for custom software. The Court cited *Touche Ross & Co. v State Bd. of Equalization* (1988) 203 Cal.App.3d 1057, in explaining that the reason for the sales tax exclusion was that: "the Legislature has recognized that the design, development or creation of a custom computer program to the special order of a customer is primarily a service transaction and, for that reason, not subject to sales tax. However, once the program has been created and in the possession of the original customer, the design or development service has been completed, and the program itself has become a tangible personal asset of the customer. A subsequent sale of that program by the initial customer can no longer be characterized as a 'service' transaction, but rather is a transfer of a tangible personal asset produced by the original programmer's services."

Although *Navistar* was a sales tax case, the Court's express statement that computer programs are tangible personal assets is not based upon a sales tax statute, and should not be limited to that context. When applied in a property factor context, *Navistar* supports the position that as soon as custom software has been developed and is placed in service in the unitary business, it is tangible personal property includable in the property factor. (Note, however, that sales tax law governed the treatment of the software development for the special order of a customer. Auditors should continue to apply a facts and circumstances test to determine whether the programmer's transaction would constitute compensation for services or a sale of tangible property for sales factor purposes (MATM 7545).)

Issues may arise with respect to determining the numerator assignment of computer programs in the property factor. CCR §25129(d) provides that the numerator of the property factor shall include the tangible personal property "owned and rented by the taxpayer and used in this state." In some cases however, the tangible storage medium of the software (the disks) may be kept at one location, but the

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program itself will be accessed and used through computers in many states. Since it is the tangible elements of the software that result in its inclusion in the property factor, the consistent approach is to assign the software to the state where the tangible elements are located. If this does not fairly reflect the taxpayer's business activities within California, it may be necessary to develop an alternative method under the authority of R&TC §25137.

Reviewed: December 2002

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7153 Expense Vs. Capitalization

Pursuant to IRC §174 and R&TC §24365 (and IRC §197 for property acquired after August 10, 1993), taxpayers have the option to expense research expenditures and software development costs currently, or to capitalize the costs.

For property factor purposes, property owned by the taxpayer is generally valued at its federal tax basis at the time of acquisition and adjusted by any subsequent capital improvements (CCR §25130(a)(1)). Capitalized research and software development expenses attributable to programs are considered to be capital improvements, and are therefore included in the value of the property. An issue may exist with respect to how these costs should be assigned to the numerator. The auditor will have to determine how best to achieve the allocation. One alternative is to prorate the costs among the copies of the program that have been produced. Another alternative may be to prorate on a receipts basis (similar to the way that CCR §25137-8 prorates the value of films based on the ratio of gross receipts in release in California over films in release everywhere -- see MATM 7740).

If the taxpayer elects to expense research and software development expenses currently for federal and state purposes, no adjustment is made to the federal tax basis of the property. Therefore, the expenses would not be included in the value of the programs for property factor purposes. An analysis supporting this conclusion can be found in *Appeal of Pauley Petroleum, Inc.*, Cal. St. Bd. of Equal., February 1, 1982. (That decision dealt with intangible drilling costs, which were expensed by the taxpayer. Although the regulations have since been revised to expressly include intangible drilling costs in the property factor whether or not they have been expensed, the SBE's analysis is still valid with respect to other types of expenditures.) For some software companies, exclusion of expensed software development costs from the property factor may result in a situation where the business activity within the state is not reasonably reflected. If the problem is extreme enough to cause distortion, then the auditor may consider whether a modification to the apportionment formula is appropriate in accordance with R&TC §25137.

Occasionally, taxpayers may elect to expense research and software development costs for federal purposes, and capitalize the costs for state purposes, or vice versa ([FTB Notice 92-6](#)). The general rule is that *federal* tax basis is used in the property factor. However, in cases where state law does not conform to federal law and the issue is material, auditors may consider whether the facts of the case warrant use of the California tax basis as an exception to the general rule.

Reviewed: September 2003

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**7155 FOREIGN PROPERTY**

The property factor should be calculated in the currency of the parent corporation unless the taxpayer and FTB agree that calculating the factor in U.S. dollars (or any other currency) fairly reflects the taxpayer's activities in California (CCR §25106.5-10(c)(1)). The following translation rules apply:

Fixed assets are translated at the historical exchange rate as of the date of acquisition.

Rented property, capitalized at eight times the net annual rental rate, is translated at the simple average of the beginning and end-of-year exchange rates.

Inventories are translated at the historical exchange rate as of the date of acquisition. The date of acquisition will depend upon the inventory method used by the taxpayer (i.e., LIFO, FIFO, etc.).

The detailed information needed to apply these translation rules is not always available to the auditor. Therefore, it is often necessary to make a reasonable estimation based upon available information. For example, rather than using the actual exchange rate as of the date an asset is acquired, it may be reasonable to apply the average exchange rate for a given year to all assets on hand that were acquired during that year. A translation schedule using this method is shown on page 5 of Exhibit H.

If the taxpayer's asset records are not grouped by acquisition year, it may be necessary to estimate the annual acquisitions. For example, assume a balance sheet reflects property, plant and equipment of \$1,000,000 as of December 31, 1990. By December 31, 1991, the property, plant and equipment balance is \$1,200,000. It may be reasonable to proceed with the translation illustrated in Exhibit H under the assumption that the \$200,000 incremental increase in the property balances is representative of the property acquired during 1991. On the other hand, if the taxpayer had material asset dispositions during the year, then using the incremental change in property balances may not be reasonable. The auditor will have to consider the facts and circumstances of each case, and the materiality of the issue.

The translation should be applied consistently for both the numerator and denominator of the property factor. If the numerator is stated at original cost in U.S. dollars, and foreign assets in the denominator are translated at a current exchange rate, the denominator may be overstated or understated depending upon the history of the foreign country's exchange rate relative to the U.S. dollar. As always, an auditor faced with this issue should consider materiality.

Reviewed: December 2002

**7160 GROWING CROPS**

There is no regulation covering the valuation of growing crops in the property factor, so crops are subject to the general rule of valuation at federal tax basis. The property factor will therefore generally include only long-term crops such as orchards, vineyards, etc. because the costs associated with annual crops are normally expensed rather than capitalized (Treas. Reg. 1.162-12).

If the taxpayer does not elect to currently deduct expenditures for lime, fertilizer, etc., those costs are capitalized and included in the federal tax basis (IRC §180, R&TC §24377). Although the average value of the capitalized costs will be included in the property factor, they should be removed from the factor at the end of their useful life. The rationale for removing the costs is based on the fact the soil amendments are no longer available for use or capable of being used in the trade or business (see MATM 7140).

Reviewed: December 2002

**7170 INVENTORIES**

Inventories are included in the factor in accordance with the valuation method used for federal tax purposes (CCR §25130(a)(2)).

Foreign entities, which are not included in the federal return, may adjust their book inventory values to reflect the inventory valuation method used for computing unitary business income. Translation of the original cost of foreign inventories to U.S. dollars should be made using the exchange rate as of the date(s) of acquisition of the inventory (CCR §25106.5-10(c)(1)(C)). The date that the inventory is deemed to have been acquired will depend on the taxpayer's method of inventory valuation. Under the LIFO method, for example, the taxpayer will have multiple layers of inventory with different acquisition dates.

Reviewed: December 2002

7171 Work In Process

Work in process inventory is the exception to the rule that property under construction may not be included in the factor (CCR §25129(b)). Work in process inventory is valued in the same manner as it is for federal income tax purposes.

Reviewed: December 2002



## 7172 Excise Taxes

Excise taxes are imposed on certain goods such as alcoholic beverages, tires, and tobacco products. Since excise taxes are capitalized as part of the cost of the inventory for federal tax purposes (Treas. Reg. §1.263A), they are included in the value of inventory for property factor purposes.

Reviewed: December 2002

## 7173 Intercompany Profits In Inventory

Intercompany profit in inventory occurs when sales of products are made between members of a combined group. The department's policy, as set forth in Publication 1061, *Guidelines for Corporations Filing a Combined Report*, is that the intercompany profit in inventory should be eliminated from combined income (See MATM 6070). Correspondingly, the profit in inventory should also be eliminated from the beginning and ending inventories for purposes of computing cost of goods sold and for property factor purposes.

If the intercompany profits in inventory are material or if the taxpayer has eliminated the profits for income purposes, the auditor should verify that they have been eliminated from the property factor. Since intercompany profits in inventory are eliminated under GAAP, reconciliation of the Schedule R inventory to the financial statements may identify whether the elimination has been picked up for factor purposes. If an adjustment is necessary, the amount of intercompany profits in inventory can be found in the consolidating adjustments to the financial statements.

Reviewed: December 2002

**7174 Verification Of Inventory In Denominator**

The auditor should ascertain that the average inventory per the balance sheets agrees with the inventory value included in the property factor. Any material differences should be explained.

Since beginning and ending inventory balances are a component in determining the cost of goods sold, the inventory accounts are subject to scrutiny by the IRS. The Federal Form 1120 balance sheet may therefore be used to verify inventory. The auditor should also be alert to the fact that RAR adjustments to cost of goods sold may affect the inventory balances. If material adjustments to cost of goods sold are noted in the summary of federal adjustments, the RAR detail should be reviewed to determine whether the property factor would be affected.

Reviewed: December 2002

**7175 Verification Of Inventory In Numerator**

In addition to inventory that is located at a taxpayer's owned or rented location, the numerator of the property factor will also include inventory stored in a public warehouse or on consignment to a customer in this state. Inventory in transit to California is also includable in the numerator (see MATM 7176).

Generally, a taxpayer will have records that will list inventory by location in the various states. In addition to reconciling the inventory included in the numerator to this list, the auditor should ensure that the total for all the states/countries on the list agrees with the total inventory in the denominator. If there are differences, some inventories may be excluded from the by-state list. Another reason for differences may be that the by-state lists often do not reflect consolidating adjustments, and may therefore include intercompany profit in inventory.

Reviewed: December 2002

## 7176 Inventory In Transit

Property in transit to California is includable in the numerator of the factor even though it may not yet be physically present in the state by year-end (CCR §25129(d), also *Montgomery Ward & Co. Inc. vs. Franchise Tax Board*, 6 Cal.App.3d 149 (1970)).

In *The Appeal of Craig Corporation*, Cal. St. Bd. of Equal., March 3, 1987, one of the issues involved a disagreement over which state was the "destination" of inventory in transit. The taxpayer purchased the majority of their inventory from the Far East for distribution and sale throughout the U.S. and several foreign countries. All inventory ordered from manufacturers in the Far East and ultimately destined for U.S. markets was shipped to the taxpayer's California office. Upon receipt in California, the bulk shipments were subjected to quality control inspections and compliance with import and customs laws, and the products were separated for shipment to the various regional centers. The goods generally remained at the California facility for 1 to 10 days.

The taxpayer argued that to the extent the goods were ultimately destined for regional centers in other states, they remained "in transit" until they reached that ultimate destination and should not be included in the numerator. The SBE agreed with FTB that the goods in transit from the Far East were includable in the numerator. Their analysis stated that the goods did not remain in transit during their stoppage in California because the stoppage was not due to lack of immediate transportation, but was for the taxpayer's own purposes. Once the goods left the California facility for out-of-state regional centers, they would again be in-transit, and only at that time would they be considered to be destined for the states in which those centers were located.

The reconciliation of the taxpayer's by-state inventory lists to total inventory in the denominator may identify if inventory in transit has been omitted from the factor. Examination of bills of lading will reveal the destination of inventory in transit.

If the auditor is unable to identify the destination of inventory in transit through examination of the taxpayer's records, the auditor may consider using the following formula to estimate the inventory destined for California:

|   |          |                                  |   |                                    |
|---|----------|----------------------------------|---|------------------------------------|
| Inventory identified at the<br>California location<br><b>over</b> | <b>X</b> | Total<br>inventory in<br>transit | = | California<br>inventory in transit |
| Total inventories<br>everywhere less inventories                  |          |                                  |   |                                    |

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated**

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in transit

Reviewed: December 2002

**7180 LEASEHOLD IMPROVEMENTS**

Leasehold improvements are treated as property owned by the lessee. This treatment applies regardless of whether the lessee is entitled to remove and retain possession of the improvements upon expiration of the lease. Accordingly, the original cost of leasehold improvements is included in the property factor. The value of leasehold improvements is *not* capitalized by eight. (CCR §25130(b)(5)).

Reviewed: December 2002

## **7185 MOBILE OR MOVABLE PROPERTY**

Mobile or movable property includes construction equipment, trucks, leased electronic equipment, and other similar types of assets that may be used by the taxpayer both within and outside the state during the taxable year. This property presents no special problems with respect to the denominator of the property factor.

For purposes of the numerator, the original cost (or net annual rental expense capitalized by eight) of mobile or movable property is assigned to this state on the basis of total time spent within the state during the year (CCR §25129(d)). The regulation makes an exception for automobiles assigned to traveling employees. Such automobiles are included in the numerator if they are licensed in California.

Certain industries are subject to special formulas for dealing with mobile or movable property. For further discussion of these industries, see MATM 7735 (Air Transportation Companies), MATM 7765 (Bus Lines), MATM 7725 (Commercial Fishing), MATM 7770 (Freight Forwarding Companies), MATM 7760 (Sea Transportation Companies), MATM 7745 (Railroad Companies), MATM 7755 (Truck Lines).

The information necessary to determine the proper assignment to the numerator is often difficult to obtain and apply at audit. Therefore, if the mobile property owned or rented by the taxpayer is material to the factor, the auditor should first review the taxpayer's method of assigning the property to the numerator for reasonableness. If it is determined that an adjustment is necessary, the auditor should ask the taxpayer to explain how the location of the property is tracked so that the appropriate documents can be requested. The following formula may be used to determine the value assigned to California:

Number of days spent in  
California during the taxable  
year

**Over**

**X**

Original cost (or  
net annual rent x  
8)

**=**

Value assigned to the  
numerator

Total number of days used or  
available for use in the unitary  
business during the taxable  
year



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Reviewed: December 2002

**7190 OFFSHORE AND OUTERSPACE PROPERTY**

Offshore property generally consists of oil drilling rigs, pipelines, telephone cables, and similar assets. Since the use of these assets is generally restricted to the oil and gas industry (MATM 7795) and the telecommunications industry (MATM 7805), discussion of the treatment of offshore property in the factor may be found in those sections of the manual.

Outer space property generally consists of communications satellites. The treatment of such property in the factor is included in the discussion of the telecommunications industry (MATM 7805).

Reviewed: December 2002

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**7195 PARTNERSHIP PROPERTY**

If a partnership's activities are unitary with the taxpayer's activities under established standards (disregarding the ownership requirement), then the taxpayer's share of the partnership's property will be included in the property factor (CCR §25137-1(f)).

The partnership's real and tangible personal property both owned or rented and used during the taxable year in the regular course of the unitary business is determined in accordance with the normal rules as set forth in CCR §25129 - CCR §25131 and CCR §25137. Such property shall be included in the factor to the extent of the taxpayer's interest in the partnership.

The value of property, which is rented by the taxpayer to the partnership (or vice versa) is either excluded from the property factor or eliminated to the extent of the taxpayer's partnership interest as necessary to avoid duplication.

**Example 1**

Corporation A's interest in Partnership P is 20 percent. Corporation A's distributive share of Partnership P's income is included in A's unitary business income. Corporation A owns a building (original cost of \$100,000), which is rented to Partnership P for \$12,000 per year. Corporation A must include the original cost of \$100,000 for the building in its property factor. Since the entire value of the building is already represented in the factor, no portion of P's capitalized rents attributable to the building will be included.

**Example 2**

Same facts as in Example 1, except Partnership P owns the building and rents it to Corporation A. Corporation A will include \$20,000 (20% of \$100,000) of the original cost in its property factor because of its interest in Partnership P. Since only 20% of the cost is reflected in the factor, Corporation A will also take into account \$9,600 (\$12,000 less 20% thereof) of rental expense into its property factor in order to give weight to the rented building used in Corporation A's operation. The full value of the building to be included in the property factor of Corporation A is \$96,800 (\$20,000 plus 8 x \$9,600).

Special rules for the apportionment of business income with respect to unitary partnerships engaged in long-term construction contracts may be found in CCR §25137-1(h).

Examination of items making up "Other Income" (line 10 of the 1120 return) will usually indicate whether the taxpayer owns partnership interests. The annual reports or SEC 10-Ks may also discuss significant partnership relationships. If the taxpayer has interests in unitary partnerships, the reconciliation of the property factor to the financial statement balance sheet should identify if

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partnership property has been included in the factor (if the property in the denominator matches the average property per the balance sheet, partnership property was not included). Partnership financial statements (or copies of partnership returns if financial statements were not prepared) can be used to determine the appropriate amounts to include in the factor.

Reviewed: December 2002

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**7200 PROPERTY SUBJECT TO A LEASE**

Lease transactions are broadly classified as either operating leases or financial leases. An operating lease is a lease in which the lessor retains the asset on its books and claims the depreciation deduction, and the lessee deducts rental expense. Financial leases are deemed to be financing transactions or conditional sales contracts rather than true leases; therefore, the assets are capitalized on the books of the lessee rather than the lessor. The lessee is entitled to the depreciation deductions, and the rent expense payments are considered to be nondeductible payments in consideration for the asset. The lessee establishes a corresponding liability account for the present value of the future lease payments discounted at their incremental borrowing rate. The lessor reports gain from the sale of an asset.

Except for "safe harbor leases" (see MATM 6090 and MATM 7205), California treatment is the same as federal with respect to whether transactions should be treated as operating leases or capitalized as conditional sales contracts. The determination is based on facts and circumstances, and Federal case law and IRS guidelines provide guidance. See [FTB Legal Ruling 419](#) (1981) for a summary of the law in this area. For financial statement purposes on the other hand, GAAP provides an essentially bright-line test that classifies leases as capitalized leases if one or more of the following criteria is met:

By the end of the lease term, ownership of the leased property is transferred to the lessee.  
The lease contains a bargain purchase option.

The lease term is substantially (75 percent or more) equal to the estimated useful life of the lease property.

At the inception of the lease the present value of the minimum lease payment, with certain adjustments, is 90 percent or more of the fair value of the leased property.

The existence of financial leases will be disclosed in the notes to the financial statements. Since leases that are treated as capitalized leases for financial statement purposes are not necessarily treated as conditional sales contracts for tax purposes, the financial statement treatment of leases is not controlling for California. With respect to the lessee, federal Schedule M-1 adjustments adding back depreciation expense and deducting rent expense will indicate that leases have not been capitalized for tax purposes. If this treatment is determined to be acceptable, the auditor should verify that the rent expense has been capitalized by eight in the property factor and that the original cost has been excluded. With respect to the lessor, the fact that leases have not been capitalized for tax purposes will be indicated by Schedule M-1 adjustments deducting tax depreciation on leased property. If satisfied with this treatment, the auditor should verify that the original cost of the asset is included in the factor.

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The auditor should also verify that the taxpayer has treated leased assets consistently in both the denominator and numerator of the property factor.

Reviewed: September 2003

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7205 Safe Harbor Leases

Between 1981 and 1983, federal law provided a safe harbor lease election that treated certain transactions as leases rather than financing transactions, even though the transactions would not otherwise qualify as leases. See MATM 6090 for a discussion of the safe harbor provisions and an example of how the transactions are structured. Since California never conformed to these provisions, transactions entered into under a federal safe harbor lease election are generally treated as sale/leasebacks or conditional sales contracts for state purposes.

For federal purposes, the "lessor" in a safe harbor lease transaction is deemed to be the owner of the leased assets, and the "lessee" is allowed to deduct rent expense. California disregards this treatment and considers the assets to be owned by the "lessee." Accordingly, the assets subject to the safe harbor lease will not be included in the property factor of the lessor. The lessee will include the assets in the factor at their original cost, less the amount of any cash down payment received from the lessor. The lessee's rent expense is disregarded, and is not reflected in the property factor.

**Example:** Corporation X acquires property for \$1 million. In a transaction structured pursuant to the safe harbor rules, X transfers the property to Y for \$100,000 in cash and a note for \$900,000 plus interest. Y then leases the property back to X for an amount of rent exactly equal to Y's \$900,000 net obligation plus interest. The property will not be reflected in Y's property factor. X will include the property in its factor at a value of \$900,000 (\$1 million original cost less \$100,000 cash received from Y). No capitalized value of rent expense is included in the factor.

If the Schedule M-1 discloses that transactions are being reported under the safe harbor lease rules for federal purposes, the auditor should verify that the lease transactions have not been reflected in the property factor. Since safe harbor leases are not recognized for financial accounting purposes, the reconciliation of the denominator of the property factor to the financial statement balance sheets may identify whether the taxpayer has reflected such leases in the factor. If the taxpayer has based its property factor on financial statement figures, the taxpayer's apportionment workpapers may also identify whether adjustments were made to reflect the lease transactions. Care should be taken in determining the source that the taxpayer used to compile their apportionment workpapers however, because if the figures are based on the federal Schedule L balance sheet, the safe harbor transaction may already be included in the base and separate adjustments would therefore not be found in the apportionment workpapers.

If the taxpayer is involved in safe harbor lease transactions, the auditor should ensure that the appropriate state adjustments have been made -- see MATM 6090.

Reviewed: December 2002

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**7210 WASTING ASSETS (NATURAL RESOURCES)**

Mineral deposits and oil reserves are included in the property factor at original cost. In accordance with the general property factor principles, no reduction to cost is made for depletion.

Capitalized expenditures are included in the property factor. For taxable years beginning on or after January 1, 1990, all capitalized intangible drilling and development costs are included in the property factor even if they have been expensed for federal or state tax purposes (CCR §25130(a)(1)).

An amount representing royalties paid in connection with the extraction of natural resources generally is includable in the property factor, so long as the property for which the royalty payments are made is actually used by the taxpayer. The amount to be included in the taxpayer's property factor is determined by multiplying the annual royalties paid times eight. [FTB Legal Ruling 97-2](#) provides that such royalties shall be treated as equivalents to rental payments. Also, the State Board of Equalization in *Appeal of Proctor and Gamble* concluded that CCR §25137(b)(1)(B) authorizes the capitalization of royalties in a case such as this.

For additional discussion of the property factor treatment of natural resources, see MATM 7780 (Mining) and 7795 (Oil & Gas Industry).

Because timber is a renewable resource that grows back, it is not treated as a wasting resource. See MATM 7810 for the treatment of timber properties in the apportionment factors.

Reviewed: September 2003